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TAGS: ECON EFIN EINV CH HK
SUBJECT: FOREIGN EXCHANGE RESERVES: PROBABLE INVESTMENT IN
NEW ASSETS WITH ATTENTION TO MARKET STABILITY

Classified By: A/ECON MINCOUNS CHRIS BEEDE; REASONS: 1.4 (B/D)

SUMMARY

¶1. (C) Top officials from the State Administration of Foreign Exchange (SAFE) said in a January 25 meeting with Treasury Department Deputy Assistant Secretary for International Monetary Affairs Mark Sobel, Finatt Loevinger, and Econoffs, as well as a January 23 meeting that took place before Sobel's arrival, that SAFE will place a higher emphasis on long-term returns and a lesser emphasis on liquidity in its management of foreign exchange reserves. They stressed, however, that any change would be gradual and done in a way that minimizes market volatility, particularly with regard to United States Treasury bonds. They noted that SAFE has already extended the maturity of its fixed income holdings beyond the consensus expectations of market analysts. SAFE officials agreed that developing and sticking to a public mantra on the management of reserves could help minimize market uncertainty. They said that quotas for the qualified foreign institutional investor program (QFII, an inbound investment channel enabling foreigners to buy Chinese stocks) and the QDII program (an outbound channel enabling domestic investors to purchase foreign stocks) should be expanded at an opportune time. Separately, a Deutsche Bank economist in Hong Kong told us on January 18 that he believes China is considering investing some foreign exchange reserves in shares of companies based in emerging markets but traded in large and liquid stock exchanges (such as American Depository Receipts). END SUMMARY

MEETINGS WITH SAFE

¶2. (C) On January 25, Treasury Department Deputy Assistant Secretary for International Monetary Affairs Mark Sobel,

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Finatt Loevinger, and Econoffs met with SAFE Deputy Administrator Wei Benhua and Deputy Director General for Reserve Management Yin Yong, following up on a January 23 meeting between Finatt, Econoffs, and SAFE DG for General Affairs Liu Guangxi.

CARE WITH PUBLIC COMMENTS

¶3. (C) In both meetings, Sobel and Loevinger stressed that management of China's foreign exchange reserves is a sovereign decision, though the United States Government has an interest that public statements not contribute to market uncertainty and a rise in risk premiums. Wei agreed that, just as in foreign exchange policy, developing and sticking to a public mantra on the management of reserves could help minimize market uncertainty. Yin asserted that China had not officially even stated a reserve management policy. He admitted, however, that some government officials in China have made public comments that have impacted markets.

DIVERSIFICATION WITH MARKET STABILITY

¶4. (C) SAFE's Wei, Liu, and Yin said that China's reserves are adequate to meet short-term liquidity needs, such as terms of trade shocks or shifts in market sentiment. As a result, SAFE can now place less emphasis on safety and liquidity and more emphasis on achieving higher long-term returns. However, any movement into new assets will be done in a way to minimize volatility in financial markets. Yin noted that in determining the foreign currency composition of its investments, SAFE considers: (1) the composition of its current and capital account transactions as well as its foreign liabilities; (2) the liquidity of foreign currency markets; and (3) the expected return on foreign currencies.

¶5. (C) DG Liu separately told Finatt and Econoffs that he had a "message": China has a stake in the stability of foreign financial markets and has no interest in doing anything that would increase the volatility of, or erode, the value of United States dollar (USD) denominated assets, particularly United States Treasury bonds. As China contemplates changes

in its management of foreign exchange reserves, it will act in accordance with these principles, said Liu.

¶6. (C) Separately, Deutsche Bank Managing Director Jun Ma told Finatt and Econoff in Hong Kong on January 18 that, based on talking with his Chinese Government finance contacts, he expects an entity to be created along the lines of Singapore's Government Investment Corporation (GIC). As Ma sees it, China is likely to focus on acquiring stocks with high growth potential, especially those that offer underlying exposure to emerging market economies. Given SAFE's size, it will need to operate in large and liquid markets and thus is likely to focus on instruments like American Depository Receipts (ADRs) of corporations based in non-OECD countries. (Note: ADRs currently trade in the United States and are a means for United States investors to buy into foreign corporations not actually listed on United States exchanges. End Note.)

CHINESE FOREIGN ASSETS NOT LARGE, BUT GOVERNMENT OWNED
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¶7. (SBU) Liu acknowledged that China's officially-held stock of foreign exchange reserves is the world's highest (USD 1.066 trillion as of 12/31/06), but noted that China's overall foreign assets, considering both private and public holdings, are not exceptionally large, totaling USD 1.3 trillion, as compared to 11 trillion for the United States, 4.8 trillion for Japan, and 3.5 trillion for Germany. As Liu sees it, there is much room for expansion of non-official foreign currency denominated assets, which the government is trying to encourage.

CREATION OF CHINESE DEPOSITORY RECEIPTS

¶8. (SBU) Liu noted that SAFE is undertaking research on

creating Chinese Depository Receipts (CDRs). (Note: A CDR would be a locally issued and traded financial instrument with the underlying foreign stock shares held by mainland banks; the net effect would be that local investors would have a vehicle, in addition to the QDII, for investing in foreign stocks. End Note) State-controlled media has speculated that CDRs would enable Hong Kong-based Red Chips (subsidiaries of Chinese state-owned enterprises that are listed in Hong Kong, e.g., CNOOC Ltd and Bank of China Hong Kong) to trade their shares in Mainland China; these entities cannot list on domestic stock exchanges because they are technically "foreign." The Hong Kong Government recently published recommendations from its in-house think tank, the Central Policy Unit, calling for the introduction of "depository certificates of financial instruments issued in the HKSAR for trading on stock exchanges, interbank markets, or over the counter on the Mainland," i.e., CDRs.

STOCK MARKET BUBBLE?

¶9. (SBU) Liu acknowledged the widespread focus on the rapid rise of China's stock markets (which rose 130% in 2006). Given this concern about excessive market valuations, now is not the right time to expand foreign access to Chinese domestic shares through the QFII program. That said, Liu agreed that expanding QFII -- whose volume is presently very small relative to overall market capitalization -- is a laudable goal.

COMMENT: IMPACT OF MOVE TO RISKIER ASSETS

¶10. (SBU) Recent conversations with government officials, Chinese think tanks, and Hong Kong-based bankers and analysts suggest that Chinese foreign currency reserves will be increasingly invested in financial assets beyond fixed income, whether or not a new entity is created to manage them. These discussions indicate that changes are likely to be gradual, and that SAFE may have already been investing in longer-maturity and riskier fixed income assets for some time. As Chinese foreign exchange reserves grow beyond what is needed as a short-term liquidity cushion, SAFE officials appear to be grappling with two conflicting challenges: (1)

there is greater scope to diversify into riskier and higher-yielding assets; yet (2) SAFE is increasingly limited to markets where it can take meaningfully sized positions without causing disruption. As a result, the bulk of SAFE's investments outside of fixed income are likely to be in large and liquid financial assets and markets, most likely equities in the United States, Europe, Hong Kong (including Red Chips and H-shares), and Japan.

¶11. (SBU) Moreover, a shift towards more risky financial assets will not necessarily lead to major changes in the currency composition of reserves, given the emphasis officials place on matching the currency denomination of foreign exchange assets with the currency composition of China's current and capital flows and its foreign liabilities.
RANDT